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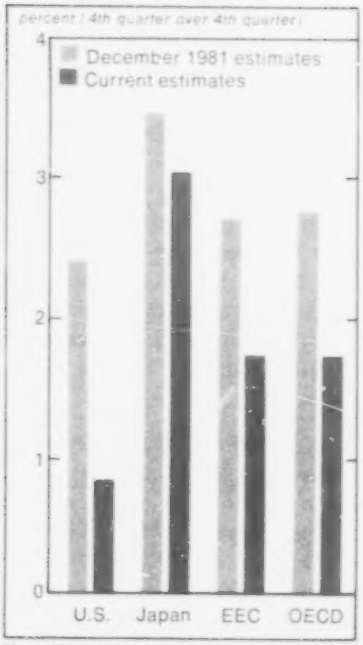
A Worsened Global Outlook for 1982

The prospects for the growth of the world economy in 1982 have deteriorated significantly since the beginning of the year. The recent reduction in the OECD Secretariat's forecast of aggregate growth in the OECD economies this year to 0.3% from 1.25% on a year average basis is but the latest in a steady progression of increasingly pessimistic projections. This shift in outlook applies for virtually every major economy, but the magnitude of change is largest for the United States: Last year most forecasters projected a rebound in the second half of 1982 sufficient to result in U.S. economic growth of at least 2.5% on a fourth-quarter-to-fourth-quarter basis. Today only the most optimistic are forecasting growth at much more than 1.5% over that time period, and an even lower rate is likely. Growth forecasts for the European economies have also been scaled back, particularly those for Germany and Italy, but the majority view is that for Europe, the change from earlier projections will be less than for the United States.

Changes in projected 1982 growth rates *



* Chase Manhattan Bank Economics Group estimates

The usual explanation for this change in outlook is the unexpectedly high level of U.S. interest rates and the unwillingness of authorities in other countries to relax monetary policy in advance of a significant fall in those rates. The first quarter backup of U.S. rates, even in the face of rapidly falling inflation, and the relative stickiness of rates in Europe (Switzerland excepted) and Japan have undoubtedly led to lower growth expectations, and hence, to lower-than-expected consumption and investment expenditures. However, other forces have also been at work. One is the apparent slowdown in import demand—particularly for capital goods—by the developing economies. Another is the continuing failure of real wages in many economies to adjust to the changes in labor productivity implied by past shifts in the price of energy.

Even though growth projections for this year have been greatly reduced, the chances for forecasting error still seem one-sided. Lower-than-forecast growth appears more likely than growth at rates above current projections. The main source of this asymmetry is the possibility of a large temporary increase in personal savings rates in economies similar to the United States, where inflationary expectations are falling much more rapidly than interest rates. If there is a silver lining to this disquieting outlook, it is that a disappointing growth performance this year would appear to enhance the likelihood that the turnaround of the world economy, when it occurs, will be followed by a period of relatively sustained recovery.

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Falkland Islands crisis overshadows Britain's economic progress.

The Falkland Islands crisis has come at an awkward time for the British government. Just as the economy was showing signs of responding favorably to the tough medicine administered over the last two-and-a-half years, the pound has come under some selling pressure and domestic interest rates have risen. Recent statistics have been reasonably favorable. Industrial production has stopped falling while the total number out of work has begun to decline. Inflation has begun to fall sharply—consumer prices in March increased 0.9%, bringing the year-on-year rate down to 10.4% from January's 12%. Perhaps more important, the underlying trend of earnings increases is running at about 7% per year while large increases in productivity have kept the increase in unit labor costs in manufacturing for the year down to a tiny 2.9% as reported in February. All of this suggested reasonable pound strength that would have given the government room to reduce interest rates as time went by. A long drawn out dispute might further weaken the pound and diminish Britain's economic prospects. Nevertheless, the markets are still hoping for an early settlement which would allow the economy to continue along the rather encouraging path of recent months.

Improvements in current account and inflation suggest further easing of German interest rates.

Economic activity in Germany continues to be sluggish. While industrial production showed small rises in each of the past two months, the index is still below the level of last autumn. Furthermore, domestic industrial order volume fell sharply in February while foreign order volume appears to be leveling off after rising dramatically in the second half of last year. On a more optimistic note, both inflation and the balance of payments have improved substantially. Consumer prices rose at a seasonally adjusted annual rate of just over 3% in the first quarter, and the April year-over-year rate fell to 5.1%. The current account of Germany's balance of payments showed a surplus of 2 billion DM in March, versus a deficit of 3 billion DM in March of 1981. These developments, together with the 4.2% wage settlement recently obtained in Germany's key metalworking industry, portend a further relaxation of interest rates in the coming months.

Mexican government enacts deficit-reducing program in support of peso devaluation.

The Mexican government has reaffirmed its commitment to trim the public sector deficit in support of February's devaluation of the peso. A new economic adjustment program has set a goal of reducing the deficit in relation to GDP by three percentage points; last year's deficit was 14% of GDP. To achieve the new target, controls and surveillances have been placed on government expenditures and some public works projects will be postponed. In addition, to help increase revenues, upward adjustments are being made in public sector prices, tariffs, and tax rates. The central bank is assisting the program by limiting credit to the government and thus, restricting the growth of the money supply. Overall, the Mexican authorities have a tough assignment. Since the devaluation, inflation has already jumped up to almost 35% at an annual rate—from 29% at year-end 1981—with further increases expected this year. The needed reductions in public spending and credit should help deflect price pressures but they are also likely to mean slower economic growth.

Puerto Rico suffering side effects of U.S. slowdown.

The Puerto Rican economy is experiencing one of its weakest periods in post-World War II history—primarily because of the U.S. recession. Tied closely to U.S. industrial activity, manufacturing output in Puerto Rico declined about 2% from July 1981 through February 1982. In addition, Puerto Rico has been hard-hit by changes in U.S. federal programs, especially the loss of CETA funds for public sector employment. This helped push the unemployment rate to over 22% in January 1982, although by March it dipped slightly to 21.9%. Furthermore, high interest rates have inhibited new construction activity on the island. A falling rate of inflation has helped to mitigate their impact in recent months, however. Through February, the consumer price index was down to an annual rate of only 6.6%. But while lower inflation will help to limit the decline in real terms, the outlook for the rest of the year suggests the economy will remain in a severe slump.

Italy's tighter exchange controls provide little relief for downward pressure on the lira.

Downward pressure on the Italian lira within the European Monetary System (EMS) prompted the Italian authorities to tighten exchange controls on April 19. The new measures reduce the period allowed for accepting payment in foreign currency for exports to 60 days from 120 and curtail payments in advance for imports. Included among those economic forces underlying the recent speculative pressure are the persistently wide differential between Italy's rate of inflation and inflation rates in some of the country's major trading partners such as Germany and a near doubling of Italy's trade deficit in February to some 2.9 trillion lire. In addition, recent downward pressure on the French franc was transmitted to the lira as foreign exchange market participants expected—probably correctly—that any adjustment of the French franc/DM rate would be accompanied by a downward adjustment of the lira/DM rate. Thus, while the Italian authorities appear to wish to avoid a unilateral devaluation of the lira's central EMS rate, a general realignment of EMS rates involving the French franc/DM rate is highly likely to include a similar adjustment for the lira.

Bangladesh to receive new aid inflows; balance-of-payments funding still tight.

Bangladesh's major aid donors recently pledged new aid totalling SDR 1.42 billion (about $1.6 billion) for the fiscal year 1982-83 beginning in July. These commitments show a respectable 14% increase in SDR terms from the level of a year before but only a 4% increase in dollars, because of dollar appreciation. Quick disbursements of food and commodity aid will make up some $330 million of the assistance, while project aid will account for the remainder. Combined with the existing aid pipeline, these new commitments are expected to result in an increase in net aid disbursements to perhaps $1.3 billion from just under $1.2 billion in the current year. Nevertheless, the country's export prospects remain relatively poor. And unless additional aid is forthcoming, the government will have to keep a tight rein on imports, just to be able to finance its balance-of-payments funding gap, much less build up reserves from their present low level.

Indonesia contemplating change in exchange-rate policy.

Indonesia's central bank is considering a change in the way in which the rupiah is valued against other currencies. Currently, the rupiah is effectively pegged against the U.S. dollar. And from November 1978 (when the rupiah was devalued by more than 33% from 415 to 625 against the dollar) until last fall, the rupiah/dollar rate remained essentially fixed. Over the past six months, however, out of concern for Indonesia's deteriorating trade balance, central bank authorities have been allowing small but frequent slippages. In effect, the bank now sets exchange rates daily. From December 1 through the end of April, the rupiah declined 2.8% to a level of 652 per dollar. The proposed change in exchange-rate policy would revive the idea of a basket-currency valuation, with major weight given to the DM and the yen as well as the dollar, and would allow some floating, subject to government intervention. This would give the government greater flexibility, in that if other currencies in the basket weakened relative to the dollar, the rupiah would also be allowed to similarly depreciate.

Further erosion of Kuwaiti current-account surplus expected.

Kuwait registered an estimated current-account surplus of $13.2 billion last year—down substantially from nearly $17 billion in 1980. The drop was mainly due to a sharp decline in merchandise export revenues, from $21.1 billion in 1980 to an estimated $16.9 billion last year, owing to lower gross oil exports which accounted for 85% of these earnings. Although Kuwait's average official oil price (not including additional premiums) rose by nearly 18% in 1981 to $35.08 per barrel, its oil output fell by nearly one-third to 1.12 million barrels per day. Soft oil market conditions so far this year have already forced the country to cut its official price to $32.30 per barrel and to reduce its output further to around 775,000 b/d currently. Higher world demand for OPEC oil after mid-year will probably allow Kuwait to raise its output somewhat and should prevent further official price erosion. But oil revenue will again fall sharply during 1982, pushing this year's current-account surplus down to $6.5-8.0 billion.

Indexed Bonds May Open Up the Bond Market

After receiving some attention in other countries, indexed bonds may soon be finding their way into U.S. markets. A bill has been introduced in Congress that would authorize the Treasury to issue 20-year bonds that would pay a fixed interest rate on a principal indexed to the GNP price deflator. If successful, the instrument could be used by private corporations as well.

The current interest in indexed bonds stems from the poor performance of the bond market during a period of dramatically decelerating inflation. Because of stubbornly high nominal long-term interest rates, corporations have been reluctant to borrow funds that would commit them to large interest costs over a long period of time. Moreover, owing to concerns over the impact of burgeoning debt-service costs on the federal deficit, Congress recently failed to extend the Treasury's exemption from the 4% coupon ceiling on 30-year bonds. As a result, the Treasury's May 15 refunding will not include a long-term bond issue.

Proponents of the indexing idea contend that indexed bonds would allow the Treasury to issue low-coupon long-term bonds and reduce its sizable debt-servicing costs and the resulting budget deficit, especially if inflation continued to fall. In addition, they argue, by reducing the level of interest rates, indexed bonds could enable corporations to tap long-term debt sources and lengthen the dangerously short maturity structure of their current debt obligations.

Indexed bonds have some characteristics in common with some of the already-existing debt-instrument innovations implemented in recent years by corporations. Similar to floating-rate bonds, the actual magnitude of the interest costs over the life of the bond would not be known at the time of issue. However, unlike those instruments, the size of the principal would also be unknown. Furthermore, like deep-discount issues, such as zero-coupon bonds, debt-service costs would be small relative to the final return of principal, although indexed bonds would not lock the issuer into the high interest rates that the deeply discounted instruments entail.

An example may clarify the impact of indexed bonds on interest rates. If investors expect 10% inflation annually over the life of a bond and require a 3% real return for the use of their money, conventional bonds would need to yield 13.3%–10% to ensure the purchasing power of their principal, 3% real return, and 0.3% to restore inflation's erosion of their real return (10% of 3%). With indexed bonds, however, the yearly interest rate would be set at 3%; if inflation over the year turned out to be 10%, the principal would also increase

Africa and Middle East Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1981 (est.)		BALANCE OF PA				
		6 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IM credit, mi lions of doll
Algeria	New regulations approved concerning joint ventures between Algerian and foreign companies.	Jan.	—17%	36.0*	1,935	Mar.	3,558	+ 2%	4.5	0
Angola	Materials and equipment shortages plus internal transport problems hamper industrial production.	n. a.	—	3.9	525	n. a.	—	—	—	—
Congo	Development plan for 1982-86 emphasizes infrastructure.	n. a.	—	1.2	735	Dec.	123	—44%	n. a.	0
Egypt	Public sector expenditure rising on development projects.	Dec.	—11%	22.7*	535	Jan.	1,354	—35%	1.4	88
Gabon	Budget for 1982 shows 18% increase in volume terms for investment outlays.	Dec.	—10%	3.4	6,180	Dec.	199	—85%	3.5	13
Kenya	U.K. $44 million financing package will modernize Mombasa port facilities.	Aug.	— 6%	8.0	500	March	204	—55%	1.3	260
Mali	Cereal crop in 1981/82 up 30% from previous season.	n. a.	—	0.8	120	March	19	—27%	n. a.	7
Morocco	New IMF loan program for 1982 includes credits of $580 million.	Nov.	— 1%	18.1*	896	Feb.	29	—65%	0.1	422
Niger	Revenue shortfall expected to cause cutbacks in public sector investment projects.	n. a.	—	2.2	410	Jan.	104	—16%	n. a.	0
Nigeria	Euro-credit for $250-million being negotiated for fourth leg of railway to mining region of Ajaokuta.	Jan.	—36%	86.8	1,125	Feb.	2,620	—71%	1.5	0
South Africa	Pressure on profit margins in manufacturing sector dampens investment plans.	Feb.	—26%	81.9	2,720	March	648	—46%	0.4	0
Tunisia	Joint investment bank—capitalized at $95 million—set up with the United Arab Emirates.	Dec.	+ 2%	8.6*	1,350	March	527	— 1%	1.8	0
Zimbabwe	Price freeze replaced by system of price controls.	Aug.	+22%	6.2	815	Sept.	200	—37%	1.6	—
Kuwait	Budget deficit of $1.1 billion officially forecast for 1982/83, vs. surplus of $2.7 billion in 1981/82.	Jan.	—26%	26.5	18,070	March	3,613	— 6%	6.8	0
Oman	Increase of 35% in oil export revenues last year fueled brisk pick-up of economy.	Jan.	+20%	4.8*	5,380	Jan.	1,079	—23%	8.3	0
Qatar	Inflation rate for 1981 officially put at 8.5%, up from 6.8% in 1980.	Jan.	—19%	5.0*	23,100	Sept.	347†	—10%	3.4	0
Saudi Arabia	Budget for 1982/83 projects expenditure of $92 billion, up 5% from previous fiscal year's allocation.	Jan.	— 3%	117.6*	14,050	March	33,112†	—13%	12.3	0
United Arab Emirates	Federal budget projects 1982 outlay of $6.1 billion, down 15% from 1981.	Dec.	—10%	19.4*	23,000	March	2,918†	—25%	4.4	0

*1980 †Excluding state reserves

Africa

Middle East

by 10%, and the 3% interest rate would be applied to the higher principal. This would yield the same interest payment as the conventional bond. The difference would be that the indexed bonds would eliminate inflation risk to investors. (If inflation exceeds 10%, investors in conventional bonds receive a real return less than 3%.) Consequently, these instruments should attract investors into the long-term market. Moreover, from the issuers' point of view, should inflation turn out to be less than 10% they will not be committed to high interest rates. This removal of the need to forecast inflation from both sides of the market is, in general, likely to result in lower nominal interest charges to the extent that current interest rates on conventional bonds carry an inflation-risk or volatility premium.

There are, however, disadvantages to indexed bonds, as well. First, if inflation does accelerate again, issuers could face a massive refinancing problem when the principal comes due. In particular, if a firm's product prices and nominal cash flow do not keep pace with the inflation index, it could face a future financial crisis if it issues indexed bonds now. Of course, this possible outcome needs to be weighed against the current, certain alternative of high interest costs and a heavy burden of short term debt.

Second, the tax treatment of indexed bonds has not yet been clarified by the Internal Revenue Service. In the case of zero-coupon bonds, it ruled last year that the annual increase in the value of the underlying bond is considered as a capital gain, despite the fact that the instrument generates no cash flow to the investor. Already there are some indications that the incremental increases in principal generated by indexed bonds might be regarded as dividend payments and taxed as ordinary income. The bill authorizing the Treasury's issue, however, has stipulated that indexed increments of principal be defined as non-taxable preservation of capital. A favorable resolution of this issue is crucial to the encouragement of investor demand for the instrument.

The final reservation about indexed bonds often voiced by critics is that they represent a surrender to inflation. Citing the use of such indexed contracts as labor agreements in many Latin American countries that have been unable to control their inflation rates, the opponents argue that indexed bonds present a mechanism for living with inflation rather than reducing it. However, since the Treasury would issue the first indexed bonds, the effect might well be just the reverse. By exposing itself to a potentially large liability if inflation is not controlled, the government expresses confidence that future inflation rates will recede. In fact, indexed bonds will provide the government with an incentive to actively pursue non-inflationary policies, especially after 1985, when indexation of the tax structure will eliminate the disproportionate gains in revenues the government enjoys from inflation-induced bracket creep. Moreover, by reducing the federal deficit and lowering interest rates, thereby encouraging private capital formation, indexed bonds make future disinflation all the more likely. *Carl Alan Batlin*

AYMENTS		MONEY AND BANKING							COUNTRIES
F l- ars	current influences on payments	12-month changes: latest data	consumer prices	latest data	money supply(M1)	exchange rate in U.S. dollars May 5, 1982	change from year earlier	current monetary conditions	
	Japanese awarded $250 million contract to build a new LPG plant.	Dec. '80	+10%	Nov.	+ 18%	.2235	— 8%	Money supply growing more slowly.	Algeria
	Better harvests this year should lower import bill.	n. a.	—	—	—	.0330	n. a.	Foreign exchange availability tight.	Angola
	Oil shipments in 1981 earned over $900 million—90% of total exports.	June	+16%	Dec.	+ 38%	.00332	— 9%	Net foreign asset position continues to strengthen.	Congo
	First quarter oil output averaged 670,000 b/d vs. 635,000 in previous period.	Dec.	+10%	Jan.	+ 30%	1.2200	—16%	Money supply growing steadily.	Egypt
	OPEC imposes 150,000 b/d oil production ceiling, equal to 1981 daily average.	July	+ 7%	Dec.	+ 22%	.00332	— 9%	Credit remains available.	Gabon
	Manufactured exports benefit from improved availability of imported inputs.	Dec.	+19%	Feb.	+ 8%	.1102	— 4%	Government borrowing from central bank slows.	Kenya
	Lower cotton output affects exports adversely, but gold exports rise.	Dec.	+15%	Nov.	0	.00162	—11%	Return to franc zone by year-end likely.	Mali
	Trade deficit in 1981 was $1.8 billion, up from $1.4 billion in 1980.	Nov.	+13%	Nov.	+ 14%	.1870	—12%	France providing $207 million aid this year.	Morocco
	Uranium price weakness points to further decline in export receipts.	Dec.	+24%	June	+ 15%	.00332	— 9%	Net foreign assets decline.	Niger
	Pre-shipment import inspection extended to cover all imports over ₦ 5,000.	June	+24%	Dec.	+ 8%	1.4940	—16%	Foreign exchange shortage is now acute.	Nigeria
	Ban lifted on U.S. non-military sales to S. African govt., police, and military.	Feb.	+14%	Jan.	+ 26%	.9500	—21%	Financial rand discount shrinks markedly.	South Africa
	Earnings from tourism were $547 million last year, up marginally from 1980.	Dec.	+11%	Jan.	+ 23%	1.7700	—16%	Arab-African International Bank opens offshore banking unit.	Tunisia
	Preferential trade agreement with South Africa extended indefinitely.	Sept.	+15%	Sept.	+ 8%	1.3570	n. a.	Foreign currency allocations to commercial sector reduced.	Zimbabwe
	Oil output in April reported at 775,000 b/d, down sharply from 1981 average.	Dec. '80	+ 9%	Jan.	+101%	2.5050	—31%	Money supply growing more slowly.	Kuwait
	Oil output averaged 328,000 b/d in 1981, up 15% from previous period.	n. a.	—	Nov.	+ 26%	2.8960	0	Bank credit to private sector rising steadily.	Oman
	Drop in oil output forces sharp cut in LPG exports.	n. a.	—	Sept.	+ 17%	.2747	0	Claims on private sector rising steadily.	Qatar
	Aramco oil output reported below April ceiling of 7 million barrels per day.	Dec.	+ 3%	Sept.	+ 17%	.2920	— 2%	Riyal adjusted down to 3.43 per dollar from 3.42.	Saudi Arabia
	Dubai's imports totalled $5.4 billion last year, nearly unchanged from 1980.	n. a.	—	Jan.	+ 22%	.2735	0	UAE foreign aid to be cut 50% this year.	United Arab Emirates

World Interest Rates

market rates as of May 5, 1982; bond yields as of April 30, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00	15.23	13.00 intervention rate	14.00	9.50	7.50	19.00 penalty rate 22.00	8.00	5.50	5.50
Day-to-Day Money	15.00 May 6	15.50	13.00	13.95	16.625	9.50	20.375	9.00	3.75 1-month Euro-Swiss fr. rate	7.1875
Treasury Bills 91-day, Middle Rates	12.55 discount basis	14.90	12.9375	15.00	n. a.	n. a.	19.102 85 days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	14.00 finance paper discount basis	15.30 finance paper 15% tax w/h	12.19	13.90 Certified	16.75 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	13.75	15.25 15% tax w/h	12.9375	13.90 Certified	not traded	9.40	21.70	no market	4.4375	no market
Government Bonds Long-term, new and old issues, average yield	13.55	14.82	13.54	10.722 20% tax w/h	15.95	8.77	20.53	10.05	5.00	7.211
Industrial Bonds prime, long-term, new and old issues, average yield	14.85 As Industrials	15.50	14.93	15.038	17.02	8.72	20.46	11.10	6.00	6.61
Bank Short-Term Rate to Best Borrowers (prime rate)	16.50	17.00	14.00	17.50	18.50	13.00	21.75 ½ qtrly fee on outstdng	11.00	9.50	6.00
Bank Time Deposits 3-month	14.00 Cert. of Dep.	14.75	13.50	14.75	16.50	9.00	11.50	8.75 large deposits	3.75 residents only	3.75 20% tax w/h
Eurocurrencies 3-month, asked	15.00	15.75	13.625	no market	23.25	8.875	no market	8.5625	4.25	7.00
Exchange Rates—in U.S.$ rates floating against the $	—	.8177	1.8040	.0229	.1654	.4321	.000779	.3884	.5156	.00427
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	.734 *D*	1.619 *P*	1.278 *D*	7.990 *D*	6.411 *P*	9.794 *D*	6.596 *P*	11.036 *P*	8.190 *P*

Eurodollar Deposits
(London, interbank, bid)
May 6

7-day	15.4375
1-month	15.00
3-month	14.625
6-month	14.625

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−1.829
U.S.-Canada Treasury Bills	− .886
U.S.-Canada Finance Co. Paper	− .356
Eurodollars-U.K. Local Auth. Deposits	− .119

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	14.32
Over 7 yrs.	14.43
DM Bonds	
7 yrs. and under	8.875
Over 7 yrs.	9.125

Gold Price
London afternoon fixing
338.40
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	(March) 6.8	(March) 11.6	(March) 10.4	(March) 14.1	(April) 5.0	(April) 15.5	(March) 4.7	(March) 2.8
Industrial production*	(March) −7.2	(Feb.) −7.8	(Feb.) 0	(Feb.) −2.4	(Feb.) −2.7	(Feb.) −4.2	n. a.	(March) 2.8
Trade balance† *(billions of local currency units)*	(March) −$2.64	(Feb.) C$0.95	(Jan.) −£0.13	(March) −FF5.74	(March) DM6.42	(Feb.) −Lit.2.930	(March) −SF0.50	(March) ¥496
Money supply (M1)*	(March) 5.6	(Feb.) 1.7	(Feb.) 29.1	(Dec.) 14.9	(Feb.) 0.5	(Nov.) 7.4	(Dec.) 7.4	(Jan.) 6.8
Velocity of money (M1)*	(Dec.) 5.5	(Sept.) 15.7	(March'81) 4.5	(Sept.) −3.6**	(Dec.) 7.1	(Sept.) 4.00**	n. a.	(Sept.) −1.1
Reserves minus gold *($ million, change from previous month)*	(March) −120	(March) −521	(March) −325	(Feb.) 164	(March) 74	(March) −3.213	(March) 1.578	(March) −822

* Percent change from 12 months earlier

**based on GDP

† Figures are only for the month indicated

The Caribbean Basin: A Troubled Region

The U.S. Congress is currently conducting hearings on the Caribbean Basin Economic Recovery Act: a program proposed by the Reagan Administration to make available trade and investment incentives, and financial assistance to nearly two dozen countries in Central America, northern South America, and the Caribbean. The aim of the proposal is to help lay the groundwork for revitalizing this area, which over the past decade, has become a region beset with political and economic problems. To appreciate the importance of this objective, some perspective is needed—not only on how these countries differ, but also on the problems they share and on their prospects for the future.

The Caribbean Basin is a region of immense diversity. Many of the states in the Basin are not politically independent and have varying degrees of economic association with the United States, Canada, and European countries. Political systems range widely over the left-right spectrum, while economic systems run from free market to mixed economies. The region's population in 1980 totaled 43 million, excluding Cuba, and combined GDP for that year approximated $60 billion —equivalent to that of Venezuela. The populations of the individual nations range from as low as seven thousand for the Turks and Caicos Islands to over seven million in Guatemala. And per capita income levels vary from a high of $5,100 in the Bahamas to $280 in Haiti. Languages and cultures reflect centuries of English, Spanish, French, Dutch, indigenous Indian, African, and U.S. involvement. And the Basin nations differ markedly in physical size and resource endowments.

In spite of their differences, the Basin economies share several key characteristics. First, they each have markets relatively small in size, which denies them advantages of economies of scale. And because they are dispersed geographically, they suffer from high transportation and communication costs which limit opportunities for production based on traditional export items. Second, they are dependent in varying degrees on a few primary products or on a small number of manufactured goods, tourism earnings, and migrant remittances. As such, they are highly vulnerable to the vagaries of climatic conditions and international economic/political developments. Third, of all the Basin countries, only the nation of Trinidad and Tobago has a significant amount of hydrocarbons; the rest have had to absorb the sharp rise of energy costs in recent years. Fourth, over the past five years, expectations regarding economic prospects have been raised as a number of nations have gained independence and others are on the threshold of statehood. Finally, population growth rates remain high, for the most part. And because of the surge in population growth in the past two decades, the Basin population is very young, with the median age being approximately sixteen.

Recent developments and prospects

These characteristics have combined to make the past decade a very difficult one for the Caribbean Basin. Up until 1973, the area enjoyed fast growth owing to a healthy demand for its products, relatively stable import prices, growing tourist earnings, and substantial inflows of foreign investment in the mineral and tourism sectors. Since that time, many of these conditions have been reversed. The terms of trade have turned against the region, primarily because the unexpectedly large petroleum price hikes of 1973-74 and 1979-80 have not been matched by similar increases in the prices of its exports. Moreover, the economic slowdown in the industrial countries has negatively affected the area's volume of goods and services exports. The situation has been aggravated by sectoral development and exchange rate policies that have often been biased against agricultural development and export growth, and have fostered dependence on imported petroleum.

Thus, with the exception of a few economies, the Caribbean Basin countries are experiencing severe balance-of-payments difficulties, which, in turn, have necessitated implementation of unpopular and difficult stabilization programs. Unemployment and underemployment are pervasive, with the official unemployment rate averaging in the 20%-30% range for most of the economies. And, up until recently, inflation rates have been high, reflecting not only higher import costs but also price liberalization and the elimination of subsidies under the adjustment programs.

The inevitable consequence of the economic decline in a number of these countries has been a rise in political and social tension, particularly since the population is so young and economic expectations have been raised in the context of political independence. The Central American countries are in a different situation. With the exception of Costa Rica and Panama, they are experiencing socio-political upheavals that reflect years of discontent with fixed economic and political structures.

The prospects for the Caribbean Basin economies over the next five years are mixed: Some economies will come close to achieving their growth ambitions and others will have a difficult time. This will be true even under optimistic assumptions regarding exogenous events: namely, that the area's terms of trade improve, that economic activity in the industrial coun-

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tries picks up significantly, that multilateral and bilateral assistance increases, and that normal weather conditions prevail. In general, most of the more developed economies will probably grow at a pace that, although slower than in the 1960s, will nevertheless generate sufficient employment opportunities to maintain political stability. The less developed Basin economies, on the other hand, have been more critically affected by the economic decline of the past decade. Their physical infrastructure and human resources have been so depleted that—barring large aid inflows, technical assistance, and a return of skilled workers and managers—they probably will continue to experience economic hardships, which, in turn, will put greater pressure on the socio-political situation. Political tensions are also likely to intensify as a result of the changing demographic structure. Population growth in the 1980s should accelerate since emigration of the magnitude seen in the past decade is not expected to reoccur.

Outlook for major country groups

Central America. Prospects for the Central American countries are not encouraging. Until their internal political conflicts are resolved, expectations of renewed and sustained economic growth are unrealistic. Nicaragua's economic prospects are clouded by its apparent drift toward a collectivist economic ideology. The performance of the Guatemalan and Salvadoran economies has deteriorated with the spread of civil disorder. The economic outlook for Honduras would be relatively bright if it were not for its proximity to Guatemala and El Salvador. But events in those countries have greatly decreased investor confidence and triggered capital flight. Costa Rica and Panama—which are essentially free from political disturbances—are more developed economies with sufficient physical and human infrastructure to sustain steady growth. In the case of the former, however, this assumes that a serious economic adjustment program designed to correct the current internal and external disequilibrium will be adhered to.

The Caricom (Caribbean Common Market). Except for Barbados and Trinidad and Tobago, the Caricom[1] states—which comprise most of the less developed Basin countries—will face economic difficulty. The majority of the smaller countries have gained independence from Britain within recent years, and as such, have lost budgetary assistance at a time when massive oil price increases and a spate of natural disasters have occurred. The resulting financial difficulties have impeded development progress. Many of the countries have not been able to maintain the physical infrastructure badly needed for economic development—let alone expand it. Moreover, many skilled workers and managers have emigrated, depleting the area's human resource pool. Thus, realization of economic growth will be very difficult in the foreseeable future, and greater socio-political tension is likely. But civil disturbance of the magnitude seen in Central America is not expected to occur. The extreme income inequities and political rigidity that characterize Central America are absent, and labor unions—which play a leading political role and support a parliamentary system—as well as close family ties and the Church are important stabilizing elements.

The associated states. For those economies associated with European and North American countries[2] prospects are relatively good, chiefly because they will continue to benefit from preferential trade arrangements and financial assistance. Also, they are the more developed and diversified Caribbean economies with tourism, international banking, petroleum refining (the Netherlands Antilles), and light manufacturing determining a major portion of their livelihood. They possess satisfactory levels of physical infrastructure, a sufficient number of skilled personnel, and political stability.

Other independent countries. The outlook for the remaining independent Caribbean countries is mixed. The Bahamas should prosper based on tourism, international banking, and small assembly industries. A stable political climate and tax freedom will continue to make it a good base for international operations. The Dominican Republic will be constrained from achieving rapid economic expansion by the structural problems caused by fiscal, interest rate, exchange rate, and energy policies. Nevertheless, per capita income is likely to be maintained. Haiti's prospects are marred by extremely low domestic savings and investment rates. Finally, Surinam's outlook depends a good deal on developments in the bauxite sector and on aid flows from Holland that are currently jeopardized by a deteriorating political situation.

All things considered, the proposed Reagan assistance program, if approved, is likely to produce neither quick nor dramatic results over the near term. Nevertheless, combined with the complementary programs already put forth by Canada, Mexico, and Venezuela, it could help to establish a framework for economic revival in the Caribbean Basin over the long run.

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[1] This includes Grenada, Antigua, St. Vincent and the Grenadines, Dominica, St. Lucia, Belize, Jamaica, Guyana, Barbados, and Trinidad and Tobago. Excluded from this discussion are Montserrat and St. Kitts-Nevis.

[2] These include the Netherland Antilles, the British and U.S. Virgin Islands, the Cayman Islands, the Turks and Caicos Islands, Puerto Rico, Guadeloupe, Martinque, and French Guiana. Monserrat and St. Kitts-Nevis, which are members of Caricom, are included in this category.